

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of)

Computer III Further Remand)

Proceedings: Bell Operating)

Company Provision of Enhanced Services)

CC Docket No. 95-20

COMMENTS OF THE INFORMATION TECHNOLOGY
ASSOCIATION OF AMERICA

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SUMMARY OF POSITION

In three Computer Inquiries, the Commission has recognized that monopoly local exchange carriers have the incentive and the ability to impede competition in the adjacent enhanced services market through access discrimination and cross-subsidization. The danger of such anticompetitive abuse remains very real.

Until Computer III, the Commission's chosen solution to the anticompetitive dangers presented by the BOCs' provision of enhanced services was structural separation. In Computer III, however, the Commission abandoned structural separation in favor of nonstructural safeguards. In California III, the Ninth Circuit found that the Commission's overall cost benefit analysis was flawed and set aside the Computer III Remand Order. As was the case after California I, the effect of the Ninth Circuit's decision is to return the Commission to the Computer II regime. Thus, contrary to the Commission's Notice, the issue on remand is not whether the Commission should move from a Computer III CEI regime to a full lifting of structural separation, but rather whether it should replace structural separation with nonstructural safeguards.

The record amassed in Computer III, as well as the experience of the last four years, demonstrate that the nonstructural safeguards identified by the Notice are as inadequate now in preventing anticompetitive abuse as they were when first proposed in Computer III. Despite the Notice's claims, and as the Ninth Circuit has found, CEI is an ineffective safeguard against access discrimination, both by itself and in conjunction with the Commission's "diluted" ONA regime. ONA, which was to be the "centerpiece" of the Commission's nonstructural safeguards, also is incapable of preventing access discrimination

by the BOCs. ONA's failure as a regulatory safeguard is directly attributable to the Commission's acceptance of the BOCs' common ONA model and its decision to price ONA at Feature Group rates.

The Commission's other nonstructural safeguards are also inadequate to prevent BOC access discrimination. The CPNI rules authorize, rather than restrict, discriminatory access to commercially valuable network information. The Commission's network disclosure rules, which provide the BOCs' enhanced service operations with access to interface information well before it is disclosed to competing ESPs, also provide only limited protection against access discrimination. The Commission's nondiscrimination reports are similarly ineffective; they do not provide any quantitative data regarding service interruptions, the quality of interconnections, the willingness of the BOCs to accommodate service requests, user complaints, or any other information needed to assess the quality of service that the BOCs are providing competing ESPs.

The Commission's Expanded Interconnection proceeding, while providing ESPs with certain transport functions, does not satisfy the ESP community's longstanding requests for access to the unbundled basic building blocks they need. Similarly, the Intelligent Networks proceeding, which is still pending, contemplates only limited access to the intelligence within the BOCs' networks and, more important, has side-stepped critical equal access issues. Competition in the enhanced services marketplace will similarly not forestall anticompetitive access discrimination by the BOCs. No matter how competitive the enhanced services market is or will become, ESPs remain dependent on the BOCs for the communication services they need to deliver their services to their customers.

Just as the Commission's nonstructural safeguards do not prevent access discrimination, they are also inadequate in preventing cross-subsidization. Price caps regulation does not eliminate either the incentives or the ability of the BOCs to cross-subsidize their enhanced service offerings. Moreover, as GAO has twice found, the Commission lacks the resources to enforce its accounting and cost allocation rules, which are themselves of dubious value.

Whatever the conceptual shortcomings of the Commission's nonstructural safeguards, and there are many, experience subsequent to Computer III demonstrates that nonstructural safeguards have, in practice, not been effective in preventing anticompetitive abuse. As audit after audit has disclosed, the BOCs are capable of cross-subsidizing of their unregulated activities. Experience further demonstrates that the BOCs have continued to engage in access discrimination. The BOCs have used their position as the provider of monopoly local exchange service to favor their own enhanced service operations and to disadvantage their competitors.

In addition to being less-than-effective than structural separation in preventing anticompetitive cross-subsidization and access discrimination, nonstructural safeguards impose enormous administrative costs on the Commission, the carriers, and the public. Indeed, because of their limited utility in preventing anticompetitive abuse, the Commission's nonstructural safeguards have become a paper chase in both form and substance. One need only glance at the mountains of paper which the BOCs must file and which the Commission must review in order to appreciate this point. Structural separation, by contrast, imposes relatively few burdens on the Commission and the carriers.

In addition to their many shortcomings, nonstructural safeguards produce few, if any, benefits. Certainly, there are no technological advantages to the integrated provision of basic and enhanced services. Integration plainly has not made the BOCs leaders in innovation or otherwise. The only result produced by the BOCs' integrated provision of basic and enhanced services is their ability to use their local exchange monopoly for their competitive advantage in the enhanced services marketplace. Neither the public nor competition has benefited from such integration.

Upon conducting the cost-benefit analysis required by the Court's decision in California III, the Commission can only conclude that the benefits of structural separation far outweigh any costs. Nonstructural safeguards, by contrast, produce no benefits and impose continuing costs of compliance on the carriers and oversight burdens on the Commission. Together with the increased risks of anticompetitive abuse which attend the nonstructural safeguards, these costs far outweigh any perceived benefits of integrating the BOCs' monopoly local exchange services and competitive enhanced services. The Commission should therefore affirm the continued vitality of Computer II and require the BOCs to provide enhanced services through fully separate subsidiaries pursuant to Section 64.702 of its rules.

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The Information Technology Association of America ("ITAA"), by its attorneys, hereby responds to the Notice of Proposed Rulemaking ("Notice") which the Commission issued in the above-captioned proceeding on February 21, 1995.¹ In its Notice, the Commission has solicited comment on the most appropriate regulatory mechanism to prevent the Bell Operating Companies ("BOCs") from engaging in access discrimination to the detriment of competition in the enhanced services marketplace.² The Commission's decision to undertake this analysis was prompted by the Ninth Circuit's decision in California III which, for the second time, vacated the Commission's efforts to replace structural separation with nonstructural safeguards.³

¹ See Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services, Notice of Proposed Rulemaking, CC Docket No. 95-20, FCC 95-48 (released Feb. 21, 1995) [hereinafter "Notice"].

² See Notice ¶¶ 11-12.

³ See California v. FCC, 39 F.3d 919 (9th Cir. 1994) [hereinafter "California III"].

As set forth more fully below, the provision of enhanced services through structurally separate affiliates is the most effective -- and least regulatorily intrusive -- means of preventing anticompetitive abuse on the part of the BOCs. Throughout the ten year history of the Computer III proceeding, the efficacy of structural separation in preventing anticompetitive conduct has never been seriously questioned. Nonstructural safeguards, by contrast, have twice been found inadequate by the Ninth Circuit. Significantly, little has changed since the Commission last attempted to eliminate Computer II's structural separation requirements: the BOCs continue to hold de facto or de jure monopolies in the provision of local exchange services; the BOCs continue to engage in both anticompetitive access discrimination and cross-subsidization; nonstructural safeguards continue to be inadequate to prevent either form of anticompetitive abuse; and the Commission's open network architecture ("ONA") regime still has not achieved fundamental unbundling of the local exchange network. The Commission should therefore maintain Computer II's structural separation requirements.

I. INTRODUCTION AND INTEREST OF ITAA

ITAA is the principal trade association of the computer software and services industry. Together with its twenty affiliated regional technology councils, ITAA represents more than 3,000 companies located throughout the United States. ITAA's members provide the public with a wide variety of computer services, such as software design and support, systems integration, facilities management, and network-based enhanced services. The enhanced services furnished by ITAA's member companies are used by business, government

and residential consumers, and include such diverse offerings as credit card authorization, computer-aided design and manufacturing, database retrieval, electronic mail, electronic data interchange, gateways, information management, payroll processing, transaction processing, value-added network services, and other remote access data processing services.

As an organization of enhanced service providers ("ESPs"), most of which have annual revenues of less than \$10 million, ITAA has a significant interest in the safeguards that govern the BOCs' provision of enhanced services. Because ITAA's member companies are totally dependent on the BOCs' regulated basic services to deliver their enhanced services to their customers, ITAA's members are vulnerable to cross-subsidization and access discrimination by the BOCs. In the absence of effective competitive safeguards, independent ESPs would be at a competitive disadvantage vis-a-vis the BOCs and many would likely not survive. More important, consumers would suffer from inflated basic service rates and diminished choice of competitive enhanced services.

ITAA's interest in effective competitive safeguards is not new. ITAA, previously known as ADAPSO, has actively participated in each of the Commission's three Computer Inquiries, as well as other Commission proceedings that have addressed ONA, customer proprietary network information ("CPNI"), collocation, and other competitive safeguards. ITAA also was an intervenor in California III, the case that prompted the Commission to initiate this proceeding. In the many years that have transpired since the Commission initiated the First Computer Inquiry, ITAA has consistently argued that the most effective and only proven means of preventing anticompetitive abuse is to require the BOCs to offer enhanced services through structurally separate affiliates. ITAA continues to believe

in the efficacy of structural separation -- as does the Congress -- and the inadequacy of nonstructural safeguards in preventing access discrimination and cross-subsidization.

Accordingly, the Commission should affirm the continued vitality of Computer II and require the BOCs to provide enhanced services through fully separate subsidiaries pursuant to Section 64.702 of the Commission's rules.

II. THERE IS A CONTINUING NEED FOR EFFECTIVE COMPETITIVE SAFEGUARDS TO PROTECT RATEPAYERS AND PROMOTE COMPETITION IN THE ENHANCED SERVICES MARKETPLACE.

The Commission has long recognized the potential for anticompetitive abuse when a regulated monopoly carrier offers unregulated competitive services using its own basic transport services. As early as Computer I, the Commission noted the "predictable abuses" that arise when regulated carriers engage in such unregulated activities.⁴ In Computer II, the Commission was equally mindful that large monopoly carriers, such as the then Bell System, have an incentive to extend their monopoly into the adjacent enhanced services market through "either (1) denial of access to the 'bottleneck' *i.e.*, local exchange and toll transmission facilities or (2) cross-subsidization from the monopoly service to the competitive enhanced . . . markets."⁵ Throughout the ten year history of Computer III, the

⁴ See Regulatory and Policy Problems Presented by the Interdependence of Computer and Communications Services and Facilities, Final Decision, 28 F.C.C.2d 267, 277 (1971), *aff'd in part sub nom. GTE Service Corp. v. FCC*, 474 F.2d 724 (2d Cir. 1973).

⁵ Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), Final Decision, 77 F.C.C.2d 384, 466-67 (1980) [hereinafter "Computer II"], on recon., 84 F.C.C.2d 50 (1980), further recon., 88 F.C.C.2d 512 (continued...)

Commission has repeatedly recognized that the BOCs enjoy market power in the provision of local exchange service, which gives them the incentive and the opportunity to engage in anticompetitive abuse in the enhanced services marketplace.

Access Discrimination. As the Commission first recognized in Computer II, one of the two principal means by which the BOCs can advantage their own enhanced service operations and disadvantage their competitors is access discrimination. The BOCs are in a position to discriminate against unaffiliated ESPs because all enhanced services, notwithstanding the different markets in which they are offered, are dependent on the local exchange bottleneck controlled by the BOCs.⁶ Because of this control, the BOCs are ideally situated to injure their enhanced service competitors. They can do so in two ways. First, the BOCs can provide their own enhanced service operations with superior service, attractive pricing, prompt installation and maintenance, and preferential access to information about the

⁵(...continued)

(1981), aff'd sub nom. Computer & Communications Indus. Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), cert. denied, 461 U.S. 938 (1983).

⁶ Competition in the local access market remains minimal. Although competitive access providers and wireless operators are beginning to develop "bypass" systems, they are unlikely to provide meaningful competition in the foreseeable future. Evidence that meaningful bypass facilities remain scarce today is provided by the 1992 experience of AT&T, the nation's largest interexchange carrier. In 1992, AT&T paid a mere \$19 million of a total of \$14 billion in access charges to the local exchange carriers' competitors, giving the local exchange carriers 99.86 percent of the access charges AT&T incurred. If AT&T, with all its attendant resources, can bypass the BOCs only to the extent of less than one percent of its total access expenses, plainly the BOCs retain monopoly control of the local exchange bottleneck. A study by Hatfield Associates, Inc., submitted jointly today by ITAA, MCI and CompuServe, finds that the competitive access providers' share of the total access market remains less than one percent. See Hatfield Associates, Inc., "ONA: A Promise Not Realized -- Reprise," at 7 (Apr. 6, 1995) [hereinafter "Hatfield Report"].

users, capabilities and evolution of the network. Second, the BOCs can provide their competitors with inferior service, discriminatory pricing, dilatory installation and maintenance, and minimal information about the network. In order for such discrimination to be successful, the BOCs need not pursue a constant or consistent pattern. Sporadic or well-timed harassment is more than sufficient to tarnish a competitor's reputation, impugn the quality of its service, and cause it financial harm.

The BOCs are in a position to target their competitors because they provide at least four of the communications links involved in almost every use of an enhanced service. The first link is the line between the subscriber and the central office serving the subscriber. The second link is the line between the central office and the point at which an ESP collects traffic and performs preliminary processing. Both of these links are either ordinary local loops (or their equivalent) or dedicated private lines. Although some applications require the use of one form of access to the exclusion of the other, most ESPs allow their customers to use either private lines or ordinary local loops.

The third and fourth BOC-provided links used by ESPs are those that connect their nodes (i.e., the locations at which data are collected and preliminary processing is performed) to the interexchange network and that connect the interexchange network to their data centers (i.e., the locations at which large main-frame computers, data bases and associated software are resident). These links are almost always dedicated private lines. This is true whether the ESP operates its own leased-line network, or relies on 800 service.

Because of the way in which ESPs configure their networks, there are numerous opportunities for the BOCs to target them for discrimination. First, where an ESP

network is composed entirely of private lines, there is a clear, continuing, and identifiable path between a customer and an ESP. The network may be entirely in one LATA or it may be regional or national in scope. In any case, the BOCs know exactly what those lines are used for and where they are going. As a consequence, they are easily targeted.

Where ESPs provide customers with dial-up access, the second link described above provides the BOCs with a prime opportunity to target a competing ESP's line for abuse. Through dial-up access, the customer gains access to the ESP by placing a local phone call to the nearest end of the ESP's network. That end may be a computer or a concentrator or some other device. Whatever that device is, on one side there is a BOC-provided rotary (which enables an ESP to handle multiple calls directed to one telephone number) and BOC-provided local loops. On the other side is a BOC-provided private line. The BOCs know that every call placed to that node and every bit of information transmitting that private line are part of the ESP's enhanced service offerings. This knowledge provides obvious opportunities for anticompetitive mischief.

Because the BOCs can identify competing ESP lines, there are numerous ways in which they can injure competing ESPs. Although the BOCs plainly have the ability to manipulate the local loop that connects a customer and the BOC's serving central office,⁷

⁷ With the exception of the casual home user, most businesses and home enthusiasts have at least one regular telephone line that is used solely for enhanced services. The BOCs are often advised that these lines are being used for data and, even when they are not, the BOCs have the ability to identify lines that call the number of a competing ESP and to record the frequency and length of such calls. The BOCs are thus able to target and manipulate the quality of these lines.

such action is not really necessary. The opportunities for abuse are far greater with respect to the lines that connect an ESP with the BOC's serving central office.

When installed, these lines can be of poor quality. When problems arise, the BOCs can be less-than-cooperative in isolating these circuits and replacing them with more acceptable facilities. The BOCs similarly can be lackadaisical in performing maintenance or restoring lost service. The BOCs can also manipulate the assignment of telephone numbers (which are critical to enhanced services), the availability and size of rotaries, and the provision of other services (such as Remote Call Forwarding) and equipment needed by their competitors.

The BOCs also can degrade a competing ESP's services simply by delaying the installation of new inter-office links or other facilities that ESPs might need to alleviate network congestion and reduce the number of busy signals experienced by their customers. Because of the highly seasonal nature of certain enhanced services, such as credit card authorization, the prompt installation and availability of transmission facilities are critical. If these facilities are not provided in a timely manner, a competitor's network could become overloaded, resulting in constant busy signals (in possible breach of its contractual obligations), unsatisfied customers, and lost revenues.

The potential for abuse is particularly great with respect to the private lines that connect an ESP with its customers and with an interexchange carrier's network. Because private lines carry much more traffic at significantly higher speeds than switched services, quality is especially critical. The BOCs can impair the quality of their competitors' enhanced service offerings simply by providing them with inferior circuits. Moreover, they

can do so consistent with their tariff obligations because private line tariffs ordinarily prescribe only very broad parameters of service.

Private lines also are likely targets for abuse because, when outages occur, the amount of lost traffic -- and an ESP's lost revenues -- are significantly greater than in the case of switched service. As a consequence, the BOCs can easily wreak havoc on their competitors by manipulating the speed and care with which they undertake the installation, maintenance and repair of private lines. In doing so, the BOCs not only can degrade the quality of an ESP's service, but also inflate its costs by requiring the otherwise unnecessary expenditure of funds (e.g., for line conditioning and diagnostic equipment) to compensate for the inadequacies of the BOCs' performance.

The BOCs also can exploit their knowledge about how ESPs use their networks. The BOCs know the design, nature, geographic coverage and traffic patterns of the networks operated by competing ESPs. They know the kinds of services that their competitors are offering, the extent to which these services are being used, and the customers that are using them. As a consequence, the BOCs are in a unique position to determine the size and nature of the market for a given enhanced service, the places and times of day it is being used, and the strategy being employed by their competitors to penetrate new markets. The ways in which this information can be misused are obvious.

The BOCs also are in a position to design and, equally important, price new network services to meet the needs of their own enhanced service operations. Additionally, they have the ability to structure protocols, interfaces and the like so as to render the offerings of competing ESPs less efficient or less attractive to users. The Commission has

also granted the BOCs flexibility in pricing the transport component of interstate switched and special access service. This new flexibility means that, if and when the BOCs are granted interLATA relief, they will be in a position to strike anticompetitive deals with the interexchange carriers that carry their interLATA enhanced services traffic, to the detriment of competing ESPs and interexchange carriers.

Cross-Subsidization. The second principal way in which the BOCs can advantage their own enhanced service operations and disadvantage their competitors is through cross-subsidization. Originally, the cross-subsidization problem was simple. The BOCs operated under strict rate-of-return regulation which gave them an incentive to shift costs from their unregulated activities to their regulated operations. Then captive ratepayers would subsidize the BOCs' unregulated activities. Today's price caps rate regulation, although more complex, creates the same incentives on the part of the BOCs to cross-subsidize their unregulated operations as traditional rate-of-return regulation.⁸ The "sharing" provisions of price cap rules (and the Commission's stated intent to readjust the caps if returns are too high) will perpetuate the BOCs' incentives to reduce the apparent profitability of their regulated transmission services.⁹ Because a rate-of-return standard still determines whether the BOCs are required to disgorge excessive profits,¹⁰ the BOCs will have a

⁸ See Hatfield Report at 38-41.

⁹ See Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990).

¹⁰ See id. The Commission's latest revision of the local exchange carrier price caps formulae continues to use a rate-of-return standard to calculate shared profits. See "Commission Affirms Commitment to Competition and Fair Long Distance Rate in LEC Price Cap Plan," FCC Public Notice Report No. DC 95-48, CC Docket No. 94-1 (Mar. 30, 1995).

continuing incentive to "reduce" their earnings by shifting unregulated costs to their regulated operations.¹¹

The BOCs certainly do not lack the wherewithal to fund cross-subsidies. Their operating revenues range from \$7.7 to \$12.4 billion.¹² The relative volume of switched interstate communications dwarfs that of enhanced services traffic. Thus, the shift of even a small fraction of a cent per minute would create an enormous subsidy pool. And because the BOCs control regulated local exchange monopolies, their incentive and ability to cross-subsidize are not constrained in the same way as other companies that engage in cross-subsidization or predatory pricing on an inter-temporal basis; the BOCs' monopoly franchises enable them to sacrifice profits from their enhanced services and recoup them during the same period through inflated prices for their regulated services.

¹¹ Moreover, the bulk of the BOCs' revenues originate from intrastate services outside the Commission's jurisdiction. The efficacy of state regulation varies widely, and the BOCs are adept at cross-jurisdictional manipulations to position costs and revenues where there is the least amount of regulatory scrutiny. Additionally, federal price cap regulation is based on outside indices of price levels, not simply cost factors. The steep decline in underlying costs for the provision of local exchange access services resulting from the transition from copper to fiber transmission and from ever more efficient switching technologies will likely result in increased profits. These can be used to cross-subsidize the carriers' enhanced service operations. Thus, even though the BOCs may not be able to gain an immediate increase in their overall earnings levels through cross-subsidization, they would be able to provide enhanced services at anticompetitive rate levels, set below actual costs, in their efforts to gain market share.

¹² United States Telephone Association, Phone Facts 1993, at 21.

III. THE NINTH CIRCUIT'S DECISION IN CALIFORNIA III RESTORES THE STRUCTURAL SEPARATION REQUIREMENTS OF COMPUTER II.

The Commission's chosen solution in Computer II to the anticompetitive problems presented by the Bell System's provision of enhanced services was structural separation. AT&T was required to provide enhanced services through a separate, unregulated affiliate so as to limit the opportunities for, and make easier to detect, anticompetitive cross-subsidization and access discrimination.¹³ This decision was affirmed by the D.C. Circuit in Computer & Communications Industry Association v. FCC.¹⁴ After the breakup of the Bell System and the divestiture of the BOCs, the Commission imposed the Computer II structural separation requirements on the newly formed Bell Operating Companies in the BOC Separation Order.¹⁵ That decision was also subsequently affirmed by the courts. Indeed, the Computer II structural separation regime is the only set of enhanced service safeguards that has ever survived judicial review.

The Commission's traditional reliance on structural separation is understandable. As the Commission has repeatedly recognized, structural separation is an effective and proven means of providing "protection for the regulated market ratepayer against costs transferred from the competitive market by the parent corporation, and protection for the general public against such anticompetitive activities as denial of access

¹³ See Computer II, 77 F.C.C.2d at 457-90.

¹⁴ 693 F.2d 198 (D.C. Cir. 1982), cert. denied, 461 U.S. 938 (1983).

¹⁵ See Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services, and Cellular Communications Services by the Bell Operating Companies, 95 F.C.C.2d 1117, 1120 (1984) [hereinafter "BOC Separation Order"], aff'd sub nom. Illinois Bell Tel. Co. v. FCC, 740 F.2d 465 (7th Cir. 1984).

and predatory pricing."¹⁶ Structural separation provides this protection by minimizing the opportunities for abuse and, to the extent that such opportunities still exist, by making them more visible. By separating a carrier's regulated and unregulated operations and prohibiting most sharing, structural separation eliminates most joint and common costs. As a consequence, it minimizes the need for difficult and, at times, arbitrary cost allocations and thus reduces the opportunity for improper cost-shifting.

Structural separation also deals effectively with a carrier's ability to manipulate the availability, installation, maintenance, repair, and quality of basic transmission service. By requiring a separate affiliate to acquire transmission service on the same basis as competing enhanced service vendors, structural separation not only ensures nondiscriminatory access to the carrier's basic network, but it also promotes cost-based pricing. By requiring separate marketing, structural separation prevents the misuse of customer proprietary information and the improper tying of basic and enhanced services. The requirement of a separate affiliate also provides greater certainty that network information will be disclosed in a timely and nondiscriminatory manner to all users.

In Computer III, the Commission abandoned structural separation in favor of nonstructural safeguards on the theory that structural separation imposed significant costs on the BOCs (which were never documented) and that the benefits of structural separation could be achieved through nonstructural safeguards.¹⁷ Under Computer III, the BOCs were

¹⁶ Computer II, 77 F.C.C.2d at 462-64.

¹⁷ See Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), 104 F.C.C.2d 958 (1986) [hereinafter "Computer III Phase I"]
(continued...)

initially required to file service-specific CEI plans before offering individual enhanced services on an integrated basis. The order further provided that once the BOCs had adopted ONA plans that fundamentally unbundled their networks, all structural separation requirements would be lifted. In California I, the Ninth Circuit vacated the Commission's decision in Computer III, because the Commission had not adequately explained its sudden about-face on structural safeguards and, in particular, its new-found belief in the efficacy of accounting rules in preventing cross-subsidization.¹⁸

On remand, the Commission tinkered with its accounting rules and affirmed its decision to replace structural separation with nonstructural safeguards.¹⁹ Once again, the Ninth Circuit vacated the Commission's decision. In California III, the Court of Appeals reexamined the Commission's cost-benefit analysis and concluded that, while the Commission had not committed reversible error in fundamentally changing ONA,²⁰ the Commission had failed to explain how its "diluted" form of ONA provided an effective safeguard against

¹⁷(...continued)

Order"], on recon., 2 FCC Rcd 3035 (1987) [hereinafter "Computer III Phase II Order"], on further recon., 3 FCC Rcd 1135 (1988), on second further recon., 4 FCC Rcd 5927 (1989), vacated sub nom. California v. FCC, 905 F.2d 1217 (9th Cir. 1990) [hereinafter "California I"].

¹⁸ See California I, 905 F.2d at 1238.

¹⁹ See Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, 6 FCC Rcd 7571 (1991) [hereinafter "Computer III Remand Order"], vacated in part sub nom. California v. FCC, 39 F.3d 919 (9th Cir. 1994).

²⁰ See California v. FCC, 4 F.3d 1505 (9th Cir. 1993) [hereinafter "California II"].

access discrimination.²¹ The court therefore reversed and remanded the proceeding to the Commission.²²

Although issued in response to the court's decision, the Commission's Notice seriously misapprehends the substance of the court's action in California III. According to the Notice, the issue on remand is whether the Commission should move from a Computer III CEI plan regime to a full lifting of structural separation.²³ The fundamental flaw in postulating the issue this way is that, as a result of the California III decision, there is no Computer III CEI regime in place. The issue before the court in California III was the legality of the Commission's decision to replace the structural safeguards of Computer II with the nonstructural safeguards of Computer III, including accounting safeguards, CEI and ONA. Although the court found that the Commission had adequately explained its reliance on accounting safeguards, the court concluded that the Commission had failed to justify its reliance on nonstructural safeguards to prevent access discrimination. Accordingly, the court concluded "that the FCC's overall cost benefit analysis was flawed" and set aside the Computer III Remand Order.²⁴

Neither the court's finding that the Commission had acted arbitrarily and capriciously, nor its decision to vacate the Computer III Remand Order, was limited to

²¹ California III, 39 F.3d at 930.

²² Id. at 933.

²³ Notice ¶¶ 11-12.

²⁴ California III, 39 F.3d at 930.

ONA. Indeed, the court's opinion could not be clearer as to which portions of the Computer III Remand Order were being vacated:

[W]e conclude that the FCC's nonstructural safeguards against cross-subsidization adequately respond to our concerns in California I, but that the FCC has failed to explain or justify its change in policy regarding nonstructural safeguards against access discrimination. For this reason, the FCC's cost benefit analysis is flawed and that portion of its order is arbitrary and capricious. We uphold those portions of the Order on Remand that implement CPNI rules and that preempt state regulations.²⁵

Thus, the only portions of the Computer III Remand Order that were not vacated were those dealing with CPNI and preemption. The remainder of the Computer III Remand Order approving the change from structural separation to nonstructural separation was vacated. As was the case after California I, when the court was troubled by the Commission's reliance on accounting safeguards, the effect of California III is to return the Commission to the Computer II regime.²⁶ To be sure, the court's order in California III was narrower than in California I, where it vacated the entirety of the Computer III orders. However, the only relevant difference is regarding CPNI and preemption. On the fundamental issue -- the decision to replace structural separation with nonstructural safeguards -- the effect of the court's decision is the same.

There is no basis to conclude that California III returns the Commission to a Computer III CEI regime. Although the Notice contends that California III viewed the CEI

²⁵ Id. at 933.

²⁶ See Bell Operating Companies' Joint Petition for Waiver of Computer II Rules, 5 FCC 4714, 4714 (Com. Car. Bur. 1990) (recognizing that California I returned the Commission to the Computer II regime).

regime favorably,²⁷ it can do so only by selectively and inaccurately quoting from the court's opinion. The fact is that the court found CEI to be incapable of preventing access discrimination. As the court explained:

While CEI and the nondiscrimination reporting requirements are designed to prevent BOC discrimination against other enhanced service providers where a BOC is providing its own enhanced service, these safeguards do not enable enhanced service providers to pick and choose network service elements to design and develop enhanced services. Consequently, competitors who otherwise would be able to compete effectively by offering more efficient packages of services had fundamental unbundling been accomplished might be excluded from the market entirely. Further, the network disclosure rules do not guarantee that the BOCs will provide competitors with the interconnection they need for their enhanced services. Thus, according to the analysis of the FCC in Computer III, these safeguards are not a substitute for ONA and, without ONA, are not adequate to prevent access discrimination.²⁸

It is absurd to contend that having concluded that CEI is ineffective in preventing access discrimination, the court's decision affirmed the legality of replacing structural separation with the CEI regime. Nor can CEI be justified as an interim measure. Because fundamental unbundling has not occurred with ONA, there is no better regime to which CEI will lead.

The Notice's assertion that the court intended to permit the replacement of structural separation with a CEI regime is also belied by the court's discussion of

²⁷ See Notice ¶ 11.

²⁸ California III, 39 F.3d at 929-30 (emphasis added). In other words, CEI is designed to prevent access discrimination only when an enhanced service provider wishes to provide the exact same enhanced service in the exact same manner as the BOC. If, however, the enhanced service provider can provide different services or the same services in a different manner, CEI does not even purport to prevent the BOCs from engaging in access discrimination.

MemoryCall, the voice messaging service provided by BellSouth on an integrated basis pursuant to a CEI plan.²⁹ Like the Georgia Public Service Commission,³⁰ the court found that BellSouth had discriminated against competing enhanced service providers in at least three separate ways, notwithstanding the existence of an approved CEI plan.³¹ Surely, the court did not intend to uphold an ineffective CEI regime.

The conclusion is inescapable: California III returned the Commission to Computer II. The proper question before the Commission therefore is whether it should replace structural separation with nonstructural safeguards. To answer this, the Commission must answer two questions: whether nonstructural safeguards are an effective substitute for structural separation and whether the public interest would benefit by replacing structural separation with nonstructural safeguards.³² Experience demonstrates that the benefits of structural separation cannot be obtained through nonstructural safeguards. Experience further indicates that the costs of structural separation are less, and the costs of nonstructural

²⁹ See BellSouth Plan for Comparably Efficient Interconnection for Voice Messaging Services, 3 FCC Rcd 7284 (Com. Car. Bur. 1988).

³⁰ See Commission's Investigation into Southern Bell Telephone and Telegraph Company's Trial Provision of MemoryCall Service, Docket No. 4000-U (Ga. PSC Jun. 4, 1991) [hereinafter "MemoryCall Order"].

³¹ California III, 39 F.3d at 929.

³² The Notice does raise the issue whether structural separation is more beneficial than nonstructural safeguards. Notice ¶¶ 13, 37-40. The Notice, however, queries whether structural separation ought to be imposed on the BOCs, without noting that the California III decision has already done that. The Commission should withdraw the Notice and, if it so chooses, release a new Notice of Proposed Rulemaking that accurately describes the current regulatory regime with respect to the provisioning of enhanced services by the BOCs.